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161045Z Sep 05

UNCLAS SECTION 01 OF 03 PARIS 006314

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E.O. 12958: N/A
TAGS: EFIN ECON PGOV FR
SUBJECT: FRENCH BUDGET DEFICIT FOR 2005 COULD BE 3% of GDP, THE LOWEST IN FOUR YEARS

Refs: (A) Paris 5936 (B) Paris 6311

¶1. SUMMARY. The GOF is confident its 2005 budget deficit will be 3% of GDP. This would be the first time in four years that the government complied with the EU stability and growth pact limit. However, public debt (estimated at 66.2% of GDP) considerably exceeds the EU limit of 60% of GDP. Work has begun on the 2006 budget, which is also expected to be tight. Funding new economic growth and unemployment reduction policies will make it likely that France will squeak by with another 3% deficit for 2006. END SUMMARY

2005 Budget Deficit Could Stand at 3% of GDP

¶2. On September 5, the government informed the European Commission that the 2005 budget deficit would stand at 3% of GDP, exactly the maximum permitted by the EU stability and growth pact, which limits the general government (GG) budget deficit to 3% of GDP. (GG includes central government, social security system and money spent on and by local authorities). The new forecast is based on GDP growth of 1.5-2.0% in 2005. This year, the Government had to revise GDP growth from 2.5% to 2% and to 1.5-2% (ref A).

¶3. The government slightly revised its previous forecast of a deficit of 2.9% of GDP in 2005. Nevertheless, the budget effort is an improvement compared with deficit rates of 4.2% of GDP in 2003 and 3.6% in 2004, making 2005 the first year since 2001 that the government has complied with the EU pact.

Government Confident in its Estimate of 2005 Budget Deficit

¶4. Recent data allowed the government to be confident about its new 2005 budget deficit estimate. Budget Ministry experts have said that, "tax receipts, notably the shortfall in corporate income taxes and VAT receipts is likely to be 2 billion euros, not 4 billion euros as forecast in June." Health spending has been actually growing at a lower pace than in 2004.

¶5. In addition, current analysis shows that public debt will grow to 66.2% of GDP in 2005, up from 64.7% in 2004. This considerably exceeds the EU stability and growth pact debt limit of 60% of GDP.

Budget Minister Works on 2006 Central Government Budget

¶6. In June, Prime Minister Dominique de Villepin said the government will "keep the objective of no growth in spending volume in the 2006 central government (CG) budget." He added that there would be no growth in spending value - "excluding wages" - but wages account for more than 40% of spending. Therefore, taking into account a 1.8% inflation rate forecast for 2006, CG budget spending could increase 4.9 billion euros compared with 2005. Villepin said that this would provide more maneuvering room for government priorities (employment, education, research, and security), indicating that employment budget spending will increase 10%, education and research will "benefit from new means to better achieve their missions," and "all ministries participating in the reinforcement of security of our fellow citizens will be fully staffed."

Recent Measures Narrows Government Room for Maneuver

¶7. New measures announced by Villepin in September will significantly affect the government's maneuvering room.

Based on preliminary indications, measures would add at least 4.5 billion in new spending, and a 10 billion euro increase in public investment (ref B). The 2006 CG budget will include details of the planned 2007 income tax reform (including income tax cuts (ref B), which force budget ministry staff that prepare the 2006 budget to anticipate such cuts.

¶8. A contact in the Finance Ministry told us that de Villepin has provided the general guidance for government budget policy. Implementing those policies will affect the 2005, 2006 and 2007 budgets. Our contact emphasized that budget ministry staff have to incorporate new measures in the 2005 and 2006 budgets, but noted that "nothing is final; not all the choices ("arbitrages") have been made." The Budget Ministry staff must finalize the 2006 CG budget by September 28, not September 21 as originally expected. Our contact said that the 2006 budget process was late mainly due to the 2005 appointment of the new Prime Minister, not to mention the new finance minister.

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Suspicion Grows that Budget Deficit Could Stay at 3% of GDP in 2006
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¶9. According to the economic newspaper Les Echos, the government is likely to revise its 2006 budget deficit target to 3% of GDP from 2.7%. The 2006 GG budget cannot benefit from an exceptional EDF one-time payment related to the transfer of pension payments to the government, which are going to help reduce the 2005 GG budget deficit by 0.5% of GDP. In a recent report, the European Central Bank noted that five EU excessive deficit countries, including France, would again come very close to or exceed the 3% of GDP limit in 2006, saying that France has pursued a "minimalist fiscal strategy." The government did not make any comment on a revision of its 2006 budget deficit objective.

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Finance Minister Calls Budget Deficit an Illness
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¶10. Nonetheless, Finance Minister Thierry Breton, in a summer meeting of the ruling party UMP, said that "the budget deficit is a French illness" and "public debt is running at an unacceptable level." Breton is planning to reinforce public spending controls over the next two years and remarked "the reality is that French people's taxes in 2006 will only just about cover interest payments on our debt. We have to say it plainly - for the last 27 years we have been living on credit . . . we have to get our budget deficit below 3% of GDP, not because Brussels tells us to but because it is good management." He confirmed that, over the 20-month period before France's next presidential election in 2007, the government planned to step up reforms to boost economic growth.

Health Insurance Deficit is Decreasing

¶11. Based on recent information, the 2004 health insurance budget deficit was lower than expected - 11.6 billion euros versus an initial estimate of 13.2 billion euros. The improvement over the initial estimate was due to both a lower rate of spending growth, and a higher-than-expected increase in receipts (payroll tax receipts, and general income tax contribution - "Contribution Sociale Generalisee - CSG"). The government objective for 2005 is to reduce the health insurance deficit to 8 billion euros, and to eliminate it by the end of 2007. However, in a recent report, the public accounts oversight institution "Cour des Comptes" said it had doubts about whether the GOF can balance its health insurance accounts in 2007. The institution urged the health insurance system to tighten spending controls, such as by fixing doctors' compensation.

Comment

¶12. Breton's observation about tax receipts just covering interest payments of the public debt, and the need to accommodate the succession of policy changes relayed to the Budget Ministry, ensure that staff will have a hard time once again in preparing the central government budget. The problem is how to fund priorities, cut spending in non-priority areas to reduce the budget deficit, and permit a decrease in revenue from income tax cuts in 2007. Future privatization receipts (most of which are already planned to reduce public debt) and receipts derived from economic growth may not be sufficient. It is encouraging that the GOF appears to be taking seriously the EU stability pact target of 3% for both the 2005 and 2006 budget deficits. However, despite De Villepin's promise of greater

maneuvering room for GOF priorities, the budget process appears destined to inexorably tighten the straight-jacket that the GOF social-economic model has become. The impending 2007 presidential election makes it even more unlikely that the GOF will take a gamble with its popularity to implement reforms needed to ensure durable economic growth.
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